THE RICHEBÄCHER LETTER

Monthly Analysis of Currencies and Credit Markets

NUMBER 399 **SEPTEMBER 2006**

Rising asset prices support household consumption, whereas falling asset prices damp consumption. In a scenario of collapse, the damage to balance sheets and private wealth could go as far as undermining the soundness of the financial system and threatening stability of the real economy.

— Former Fed Vice Chairman Roger W. Ferguson Jr., ***Asset Prices and Monetary Liquidity***

ALL BUBBLES BURST

Apparently, Wall Street and investors like what they are seeing lately in the U.S. economy. The catch is that they can only be so optimistic, due to an almost universal expectation that the Federal Reserve has definitely stopped its rate hikes. This, essentially, assumes that further rate hikes were the greatest imminent risk to the economy and the markets — bonds, stocks and housing.

Conversely, there is total detachment from the bad news that is pouring out of the economy. For several years, the booming housing market has made the difference between recession and recovery for the U.S. economy. Zooming house valuations provided private households with the collateral that allowed them to replace the missing income growth with a borrowing binge.

But as the housing market is sagging, this major source of higher consumer spending is plainly drying up, and most obviously and importantly, income growth is by no means catching up.

In 2005, real disposable incomes of private households in the United States increased $93.8 billion, or 1.2%, while their debts grew $1,208.6 billion, or 11.7%. Total consumer spending on goods, services and new housing accounted for 92% of real GDP growth.

The U.S. economy's recovery from the recession in 2001 has been its slowest in the whole postwar period, and in addition, it has been of a most unusual pattern. Real GDP rose by 11.7% over the four years to 2005. Within this aggregate, residential building soared by 35.6%. Consumption gained 13.4% and government spending 10%. The big laggard in domestic spending was business nonresidential investment, up only 3.6%. Net exports year for year were increasingly negative.

Most economic data have softened, with the downtrend accelerating. In the face of this fact, it could not be doubted that Mr. Ben Bernanke and most others in the Federal Reserve were anxious to stop their rate hikes. In question was only whether they would dare to do so in view of the high and rising inflation rates. They dared. They even disappointed those who had predicted the combination of a declared "pause" with hawkish remarks about fighting inflation.

In its statement, the Fed conceded:

> *Readings on core inflation have been elevated in recent months, and the high levels of resource allocation and of the prices of energy and other commodities have the potential to sustain inflation pressures. However, inflation pressures seem likely to moderate over time, reflecting contained inflation expectations and the cumulative of monetary actions and other factors restraining aggregate demand.*

When the Bureau of Labor Statistics (BLS) reported on Aug. 16 that the CPI in July had seasonally adjusted, advancing 0.4%, following a 2% rise in June, both the bond and stock markets responded with strong rallies. What, apparently, had made it so exciting in the eyes of the consensus was the fact that these bad figures had

remained in line with distinctly unoptimistic predictions. Never mind that during the first seven months of 2006 the CPI has risen at a 4.8% seasonally adjusted annual rate, compared with an increase of 3.4% for all of 2005.

It is, of course, perfectly true that monetary tightening impacts the economy and its inflation rates with a pretty long delay. The trouble in the U.S. case is that there never was any monetary tightening. There were many small rate hikes, and the Greenspan Fed had probably hoped that the higher costs of borrowing would exert some restraint on credit demand. But it has not happened. It was a vain hope.

The fact is that the credit expansion has sharply accelerated during these two years of rate hikes instead of decelerating. During 2004, when the Fed started its rate hike cycle, total credit, financial and nonfinancial, expanded by $2,800.8 billion. In the first quarter of 2006, it expanded at an annual rate of $4,392.8 billion.

Over the two years of so-called monetary tightening, the flow of new credit has effectively accelerated by 56%. In 2005, credit growth was $3,335.9 billion. Over the whole period of rate hikes, it had steadily accelerated from quarter to quarter. Borrowers and lenders, apparently, simply adjusted to the higher rates, trusting that there would never be serious tightening.

True monetary tightening would have to show first of all in declining "excess reserves" of banks relative to their reserve requirements. These have remained at an elevated level during the rate-hike years of 2004–05.

In 1991, when the Fed tightened, credit expansion slowed sharply from $866.9 billion in the prior year to $620.1 billion. A sharp slowdown in credit expansion in 2000 to $1,605 billion also happened, from $2,044.7 billion the year before. Yet this still represented very strong credit growth in comparison with the years until 1997.

A TIGHTENING FARCE

Like all central banks, the Federal Reserve has two levers at its disposal to stimulate or to retard credit and money creation. The big lever is its open market operations, buying or selling government bonds, thereby increasing the banking system's liquid reserves. The little lever consists of altering its short-term interest rate, the federal funds rate, thereby influencing the costs of credit.

It is most important to distinguish between the two instruments. True monetary tightening has to show inexorably in a slower credit expansion throughout the financial system. There is one sure way for a central bank to enforce this, and that is by curtailing bank reserves through selling government bonds.

The other lever at its disposal, as pointed out, is to influence credit costs. But the influence of the central bank on credit costs begins and ends with altering its short-term federal funds rate. During the past two years, the Fed has raised its federal funds rate from 1% to 5.25%. But long-term rates hardly budged. To the extent that borrowers shifted from the low short-term rate to the long-term rate, they encountered higher borrowing costs. But at the long end, interest rates rose less than the inflation rate.

Here are still a few other credit figures illustrating the Fed's monetary tightening since mid-2004. Total bank credit expanded, annualized, by $957.0 billion in the first quarter of 2006, against $563.5 billion in 2004. For security brokers and dealers, the two numbers were $611.3 billion, against $231.9 billion; and for issuers of asset-backed securities (ABSs), they were $663.3 billion and $322.6 billion. This is monetary tightening à la Greenspan.

Monetary tightening has one purpose: to curb credit expansion fueling the excess spending in the economy and the markets. By this measure, Greenspan's monetary tightening since 2004 has been a sheer farce. During these two years, he presided over a sharply accelerating credit boom, for which the reason is also obvious.

To equate rising short-term rates automatically with monetary tightening can, therefore, be a gross mistake. Later on, we shall explain that this is the great error of the monetarists in assessing the development in 1929 and following years. Borrowing exploded during 1927–29, despite the Fed's rate hikes, and then literally collapsed after the stock market crash.

It can be argued that rate hikes in the past have generally worked. Yes, but the central bankers of the past

never forgot to tighten bank reserves. Tighter money to them meant tighter credit, and it always showed in sharply shrinking credit figures. So it also has, in the past, in the United States. But this time, the diametric opposite has happened.

There was reserve easing. Money and credit, moreover, only became significantly more expensive at the short end. All the time, there was nothing in this to slow the housing bubble and the associated borrowing binge. Rising house prices easily offset the effect of rising short-term rates.

Does this mean that the economy can continue to grow as before? No, not at all. All excesses, if not stopped, are sure to exhaust themselves over time. That is no less true for economies than for the human body. In our view, the housing bubble is finished not because credit has become tight, but because the borrowing excesses are running against natural barriers.

One such natural barrier is the affordability of housing and the limited number of greater fools who are able and willing to pay these inflated prices. At some point, excess supply will exceed demand. We read from reliable sources that in June, sale offers of existing single-family homes were up 35%, while actual sales were down 6.5% versus a year ago. So the year-over-year "excess" supply was 42.2%.

Affordability is way down, units offered for sale are way up and price appreciation has all but stopped. It is a radical change in the market situation, which, however, has so far impacted economic activity only moderately.

Past experience with housing bubbles suggests that the first effects are in the steep fall of actual sales and in the lengthening of time until sales materialize. The markets become illiquid. Until sellers capitulate and accept lower prices, it can take a long time. In this way, apparent price stability becomes increasingly treacherous over time.

Present American folklore has it that a protracted slump in house prices is impossible. Let us say for many people it is unthinkable. And that is precisely one reason why this housing bubble could go to such unprecedented excess. The little historical knowledge we have about bursting housing bubbles is from a study published by the International Monetary Fund in its *World Economic Outlook* of April 2003. It presents past experience in a very different light. Here are some excerpts on decisive points:

> *To qualify as a bust, a housing price contraction had to exceed 14%, compared with 37% for equities. Housing price busts were slightly less frequent than equity price crashes… Most housing price busts clustered around 1980–82 and 1989–92, while equity price busts were more evenly distributed across time.*
>
> *Housing price crashes differ from equity price busts also in other three important dimensions. First, the price corrections during house price busts averaged 30%, reflecting the lower volatility of housing prices and the lower liquidity in housing markets. Second, housing price crashes lasted about four years, about 11/2 years longer than equity price busts. Third, the association between booms and busts was stronger for housing than for equity prices.*

An important theme running through the foregoing analysis is that housing price busts were associated with more severe macroeconomic developments than equity price busts. Coupled with the fact that housing price booms were more likely (than equity price booms) to be followed by busts, the implication is that housing price booms present significant risks. For this, the authors give the following reasons:

> *Housing price busts have larger wealth effects on consumption than the equity price busts…*
>
> *Housing price busts were associated with stronger and faster adverse effects on the banking system than equity price busts… All major banking crises in industrial countries during the postwar period coincided with housing price busts.*
>
> *Price spillovers across asset classes matter, as evidenced by the fact that housing price busts were more likely associated with generalized asset price bear markets or even busts than equity price busts.*

The authors then give a fourth reason, which was true in the past, but in which the situation in America today radically differs:

> *Housing price busts were associated with tighter monetary policy than equity price busts, reflecting the fact that most housing price busts occurred during either the late 1970s or the late 1980s, when reducing inflation was an important policy objective. The disinflation increased the real burden of debt, which exposed inflation-related overinvestment and associated financial frailty.*

PAST BUBBLE EXPERIENCE WAS DIFFERENT

Plainly, the authors were of the opinion that housing bubbles, when bursting, generally do considerable damage to the economy. Today, they are bound to do far more damage because their effects on the economies are far more pervasive. What is the difference between those housing bubbles of the 1970s and the late 1980s and the U.S. housing bubble of today? There are four decisive differences.

First, those past housing bubbles developed in a generally inflationary environment of rising consumer and producer prices. Central banks tightened their monetary reins to fight inflation in general.

Second, those bubbles were pure price bubbles in the sense that house prices rose faster than the general price indexes. There were no major repercussions on the economy.

Third, what the United States and many other countries are experiencing today is completely different from a house price bubble. Rising house prices are used as collateral to finance extraordinary borrowing-and-spending binges that virtually dominate economic growth in these countries. In 2005, consumption and residential building accounted for 92% of U.S. GDP growth.

Fourth, disclaiming that the rapidly rising house prices reflect inflation, the Federal Reserve has readily accommodated them. Rather, it hailed and celebrated the rising prices in a very positive sense as welcome "wealth creation." The declared intention of the rate hikes since mid-2004 was not to fight inflation, but to normalize short-term interest rates. Policymakers and economists openly invited and encouraged people to prime the bubble and to make as much use as possible of the borrowing facilities it offers.

Has Mr. Greenspan ever realized that he has turned the U.S. economy into a bubble economy? Who else among former and present policymakers and top economists on Wall Street has realized this? Some certainly have. In Japan, even policymakers frankly used this word in public. But in America, everybody painstakingly avoids this admission.

In order to eschew mentioning the dirty word, a new definition has come into general use. U.S. economic growth is neither "bubble driven" nor "debt driven"; it is "asset driven." It is a term especially invented for the American public to convey the good feeling that the U.S. economy is creating assets, while in reality, with its consumer borrowing-and-spending binge, it is consuming its capital, reflected in falling investment and soaring foreign indebtedness.

The first task, of course, is always to identify undesirable increases in asset prices, emphasis on "undesirable," classified as "asset bubbles." In this respect, Mr. Greenspan made his famous remark: *"But bubbles generally are perceptible only after the fact. To spot a bubble in advance requires a judgment that hundreds of thousands of informed investors have it all wrong. Betting against markets is usually precarious at best."*

Now compare this trivial talk of the world's leading central banker with the reasoned assessment by economists in a study by the International Monetary Fund (IMF), titled "Monetary Policy, Financial Liberalization and Asset Price Inflation," published in the *World Economic Outlook* of May 1993:

> *Financial liberalization, innovation and other structural changes in the 1980s created an environment in which excess liquidity and credit were channeled to specific groups in the markets. This includes large institutions, high-income earners and wealthy individuals, who responded to the incentives associated with the changes. These groups borrowed to accumulate assets in the*

global markets — such as real estate, corporate equities, art and commodities such as gold and silver — where the excess credit apparently was recycled several times over.

And here is a crucial part of the conclusions of this study:

To the extent that asset price changes are related to excess liquidity or credit, monetary policy should view them as inflation and respond appropriately. There is nothing unique about asset markets that would suggest that asset prices can permanently absorb overly expansionary policies, without leading to costly real and financial adjustment.

Actually, the study explicitly and precisely pinpoints the key feature of asset price inflation. It is ***"a credit expansion in excess of the expansion of the real economy."*** In 2005, a credit expansion of $3,335.9 billion in the U.S. economy was matched by nominal GDP growth of $752.8 billion and real GDP growth of $379.1 billion.

CREDIT DEMAND WITHOUT GDP EFFECTS

In the United States, credit growth since the 1980s has developed increasingly in excess of GDP growth. During the past five years of recovery, though, this discrepancy has widened to extremes that defy economic and financial reason.

We regard this escalating gap between credit and GDP growth as a very serious, however completely unrecognized, problem, and it is rapidly escalating. In the first quarter of 2006, credit expanded by $4,386.5 billion annualized.

The first obvious question is about underlying causes. This news essentially says that an ever-greater proportion of the credit expansion is for purposes other than spending in the economy, which would correspondingly add to GDP growth. Ominously, more and more credit generates less and less GDP.

The most conspicuous cause is, of course, credit-financed asset purchases. In a country without domestic savings, any asset purchases inexorably depend on credit creation.

A second major cause is the trade deficit. To compensate for the implicit extraction of spending and incomes in favor of foreign producers, additional credit expansion is needed to create spending for domestic producers.

And a third rapidly growing cause of America's unprecedented thirst for credit, as we have repeatedly explained, is certainly Ponzi finance. A large and growing part of the borrowing binge reflects the capitalization of unpaid, rapidly compounding interest. According to the available figures, barely one-quarter of the credit expansion is for GDP growth and three-quarters for these other purposes.

The question to ask in the face of these facts, of course, is whether this runaway credit expansion in relation to grossly lagging GDP and income growth is sustainable. For sure, it is not. All this prodigious borrowing and lending has been undertaken in the grossly flawed assumption that rising asset prices, rather than rising incomes, will some time in the future take care of interest payments and repayments.

Assuming the normal rule that debts have to be serviced and amortized by future income, the great mass of American consumers could never afford the debts they have incurred in recent years. For many, the borrowing has even been the substitute for lacking income growth. In real terms, in 2005, this was 1.2%, well below its growth rate of 1.9% during recession year 2001. Given the reported sharply slower employment growth, further deterioration is clearly on its way.

BALANCE SHEET ADJUSTMENT

Given this miserable growth of real disposable income and every prospect of further income deterioration, the brunt of the coming debt adjustment will largely fall on asset selling; in other words, on balance sheet adjustment.

From Alan Abelson of *Barron's*, we learned the following:

CEO Robert Toll reflected somberly "that it is the first downturn in the 40 years since we

entered the business that was not precipitated by high interest rates, a weak economy, job losses or other macroeconomic factors. Instead, it seems to be the result of an oversupply of inventory and decline of confidence. Speculative buyers who spurred demand in 2004 and 2005 are now sellers..."

Being unable to service and amortize their accumulated debts from current income, the debtors have to do it through their balance sheets, liquidating their debts by selling their assets. We come to the key question about every bubble economy: What will happen to the inflated asset prices when more and more overindebted owners have to sell? How much will asset prices fall? How much wealth destruction will follow?

The trouble in America and other countries is that the prices of the last trade, however small, are automatically carried over to the total existing capital stock. That is a pleasure for all concerned when prices soar, but it becomes very quickly very painful to lenders and borrowers when asset prices decline. There is the same tremendous leverage to the downside as earlier to the upside.

Here something comes into play for which the old economists had a special expression — "fallacy of composition." Selling assets is from the perspective of the individual, of course, the right thing to do. But when a very large number of house owners, all at the same time, decide to sell their assets in order to service and amortize their debts, something different happens. They smash their prices.

We strongly suspect that Mr. Greenspan's nonchalance toward asset and credit bubbles has its true reason in the conviction that the Fed will be able to greatly mitigate the economic and financial damage of abrupt monetary loosening while having enjoyed much greater earlier benefits from the ascending bubble.

In essence, it boils down to a cost-benefit comparison between the size of prior benefits and later damages from the bursting bubble. If monetary policy is able to limit the later damages in relation to the earlier benefits, it seems to make sense to accommodate the bubble until it ends on its own account.

For the American monetarists, it is a matter of faith that this is implicitly possible. In their book *A Monetary History of the United States*, Milton Friedman and A.J. Schwartz declare categorically: *"The monetary collapse from 1929–1933 was not an inevitable consequence of what had gone before. It was the result of the policies followed during those years... alternative policies that could have halted the monetary debacle were available throughout those years."*

In the same vein, a Fed study about Japan's protracted malaise comes to the conclusion that this could have been avoided by faster monetary easing. It is as simple as that. In this light, the general complacency about the present record-large housing bubble in the United States and its possible aftermath is hardly astonishing.

In fact, the development of the housing bubble since 2001, with its associated effects on "wealth creation" and economic growth, has among policymakers and economists generally been hailed as a greatly desirable positive.

That this is a new super-sized bubble economy waiting for its calamitous burst is apparently beyond the general understanding. To repeat the verdict of the IMF study: The key feature of asset price inflation or an asset bubble *is an expansion of credit in excess of the expansion of the real economy*. In the United States, this credit excess has reached absurdity.

And now please exchange the word "credit" for its synonym, "debt." In the end, this prodigious credit excess turns, dollar for dollar, into corresponding debt excess. The conventional answer, of course, is that these debts do not matter, because their steep rise has been matched by an even steeper rise in net worth, owing to soaring asset prices.

THREE CATACLYSMIC LEGACIES

Indeed, as is permanently trumpeted, net worth has surged as never before. Unfortunately, this compares incomparable things: *First*, the debts are definitely fixed; *second*, they require compounding debt service and repayment; and *third*, inflated asset values, created by loose money and credit, are not at all fixed. It has happened that they collapse.

To maintain asset values, permanent corresponding new monetary accommodation is required, since credit demand keeps rising. Any significant slowdown in credit growth will send asset prices crashing. This is the great difference between asset values underpinned by savings and those underpinned by credit and debt creation.

Many American economists seem to think that this kind of wealth creation is only a matter of easy money. In reality, it is all about the length of the line of "greater fools" willing and able to buy the assets at higher and higher prices. Yet there inherently comes a point where too few greater fools are left, however loose monetary policy may be. According to the reports we read, American banks and other lending institutions have been greatly inventive in lengthening the line of "greater fools" by extending credit at looser and looser conditions. There is no better recipe for a coming crash.

Another big problem with the fabulous wealth creation through rising asset values is that it adds nothing to the debtors' incomes, while the interest payments on the debts reduce them. Asset values outpace debt growth in the balance sheets, but in the income accounts, their effects increasingly diverge.

That is not grave in the short run, but it becomes fatal in the longer run, and that is what finally triggers the asset crashes and the debt crisis, even when monetary policy remains loose. Even more easing will not help. Considering the extraordinary speed of debt creation through compound interest, we think that the bubble process becomes fatal after three or four years.

Once asset prices stop rising, either because banks and other lenders begin to exert some true restraint or because the "greater fools" fall out, sooner or later, a fire sale of unimaginable proportions will begin, with everyone rushing to the door at once and asset prices crashing.

Stating this, we have the LTCM failure of 1998 in mind. It was a $100 billion problem. Frightened that financial assets of this amount could suddenly be dumped on the market, the Fed found it necessary to organize a rescue operation involving America's leading banks. The housing bubble is a problem running into many trillions of dollars, and the housing market is, moreover, totally illiquid by nature.

Fed Chairman Ben Bernanke will soon be able to prove to the world the truthfulness of the monetarist postulate that sufficient monetary easing is capable to bring a happy end of a soft landing to any bubble economy. We are sure that he will grossly fail. Events will prove the opposite: that what has gone before is decisive. The U.S. economy in the past few years has suffered tremendous bubble damage.

We describe four main causes that make bubble economies so dangerous:

(1) Bubble economies lead to a major misallocation of resources. In the United States, the exorbitant credit excesses associated with the present housing bubble leave the economy with an unsustainably high share of consumption as a percentage of GDP. The malign macroeconomic counterparts are the collapse of national saving, the huge trade deficit and depressed business fixed investment.

(2) Bubble economies begin to unravel when underlying economic conditions have deteriorated to an extent that the economy slows down.

(3) The collapse of the inflated asset prices leads to collapsing liquidity, while debt levels remain unchanged.

(4) The net result is a generally dramatic deterioration of balance sheets, both for borrowers and lenders. Seemingly good loans rapidly turn into bad loans across the financial system. The ensuing broad need for balance sheet adjustment impedes the effectiveness of monetary easing. In past house price bubbles, bad loans reached an equivalent of up to 20% of GDP.

Putting it as bluntly and briefly as possible: The key problem of a slowing "bubble economy" is not a slowing money supply, as the monetarists assert. That is a minor symptom. Ultimately, such an economy invariably ends with a clash between three cataclysmic legacies from the bubble: prior excessive spending, excessive debts, and excessive asset valuations, the inevitable collapse of which will devastate the balance sheets of borrowers and lenders.

FROM HOUSE PRICE BUBBLE TO BUBBLE ECONOMY

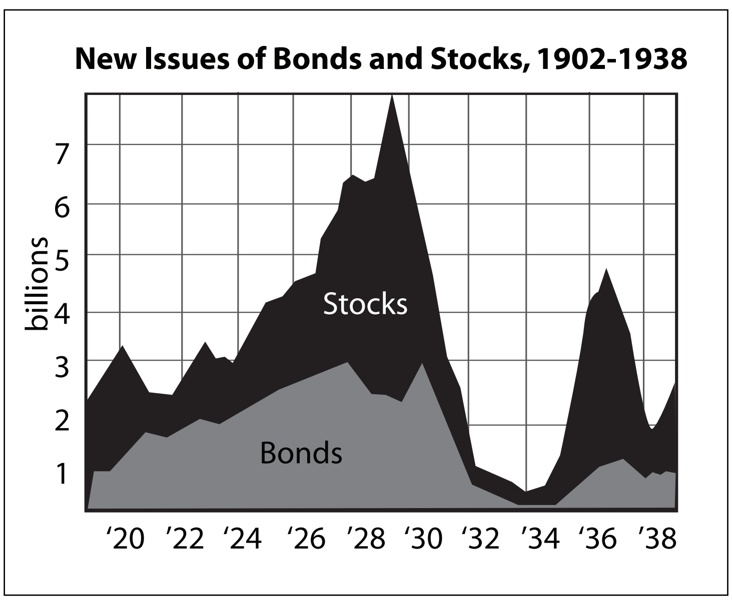
Sudden big gains in asset prices essentially have their reason in monetary looseness, with sharply accelerating credit expansion its strikingly visible sign. But this fact has always been conveniently ignored because conventional inflation rates in goods and services remained on the low side. Bizarrely, this difference between stable consumer prices and soaring asset prices was usually interpreted as a sign of particular economic health, justifying more monetary looseness.

Drawing comparisons with the past, however, we need a strict distinction. All housing bubbles in the 1970s and 1980s were pure house price bubbles. What the United States and the other English-speaking countries have experienced in recent years belongs to the totally different category of a bubble economy.

For the first time in the postwar period, housing bubbles have additionally served to provide the collateral for heavy borrowing to finance consumer-spending binges. This impact of rising asset prices on the economy as a whole is what ultimately makes a "bubble economy." It is a rare event in history.

The last case of this kind was Japan's bubble episode of the late 1980s, in that roaring equity and land bubbles fueled extraordinary investment excesses in manufacturing and commercial real estate. The famous case was the United States in the 1920s, where, over 1927–30, the booming stock market stoked a surge in consumer spending.

The outstandingly striking characteristic of an ascending bubble economy is a credit explosion in relation to GDP. The outstandingly striking characteristic of a cracking bubble economy is a literal credit implosion. In this respect, the following chart concerning birth and bust of the U.S. bubble economy in the 1920s is the most instructive piece of evidence:



The monetarists see the key evidence of overly tight money and credit in 1929–31 causing the Great Depression, in a contraction of the money supply. The broad money aggregate fell from $55.5 billion at end-1928 to $53.7 billion at end-1930. It was only in the second half of 1931 that a sharper contraction of the money supply — to $47.9 billion at end-1931 — occurred.

As we explained in the last letter, the main action in reality at the time was outside the banking system — in the securities markets. In Japan, too, just the same has been happening. Credit implosion followed credit explosion, even though monetary easing went to virtually absurd extremes. Here, the reason is all too obvious: Extensive balance sheet adjustments make monetary easing ineffective.

The very same question is irking us concerning the present situation in the United States. From our studies of the U.S. bubble economy of the late 1920s and Japan's bubble economy in the late 1980s, we have concluded that monetary easing becomes inefficient in the aftermath of a severe bubble economy.

This is for two main reasons: One arises from the great damages to the balance sheets both of borrowers and lenders owing to collapsing asset prices in relation to rigid record-high debts; the other arises from the fact that in the case of a "bubble economy," with its protracted prior credit excess, there has been heavy borrowing from the future. In the normal business cycle of the past, by contrast, tight money, driving the economy into recession, used to create pent-up demand, which made monetary easing so powerful.

Mr. Bernanke has repeatedly stated that further monetary policy will be data based. While recent data are mixed, they nevertheless point overwhelmingly downward. But considering further that the economy has been running on one single wheel, the housing bubble, and that this wheel is breaking down, the economy's incipient severe downturn is no longer in question.

The three questions presently uppermost in our mind are* first*, how fast the U.S. economy and its asset markets will turn down;* second*, how the Bernanke Fed will react; and* third*, how, in turn, the economy and the asset markets will respond to the easing.

ADDICTED TO A PERMANENT CREDIT AND DEBT DELUGE

Mindful of manifold past experience, the Fed's decision to halt its rate hikes and the accumulating news of a weakening economy have triggered strong rallies in the U.S. stock market. Investors, apparently, rush to jump aboard the train before it leaves the station. It reminded me of a sarcastic remark by Keynes: *"Men, like dogs, are only too easily 'conditioned' and always expect that, when the bell rings, they will have the same experience as last time."*

In the past, indeed, stock prices regularly took off when a central bank eased. What these people completely fail to see is that today's conditions in the U.S. economy and its asset markets have nothing in common with those days when monetary easing had these magnificent effects.

Monetary easing in the past regularly followed prior tightening, which also had created pent-up demand in the economy. Rate cuts were equivalent to removing existing tightness. As a result, the economy and markets took off.

But those conditions that used to provoke strong economic growth and asset rallies are not at all present today. There never was any monetary tightness in the first place. Instead, there has for years been a sharply accelerating credit expansion that has grotesquely run out of relation to economic activity. We see an economy and financial system that have become pathologically addicted to a permanent credit and debt deluge.

The one most important thing to realize is that credit and debt deluge creating rapidly escalating debt service obligations. What makes it worse is the fact that real income growth is at its lowest in the whole postwar era. There is every reason, we think, to investigate the cause of this extremely malign fact. But who investigates causes in the United States?

THE DOWNTURN HAS STARTED

It caused a bit of a shock that the reported real GDP growth for the second quarter came in at only 2.5%, annualized. But the true ugly surprises are by no means in the aggregate figure; they loom in the composition of that GDP growth.

Three GDP components, which had been the pillars of the U.S. economy's recovery, have slumped over the past few months. These are consumer durables, nonresidential investment and residential construction.

The direct effects of their slowdown, or even decline, are straightforward. Over the past two years, 2004–05, the three have each contributed about 0.5 percentage points to real GDP growth per year, adding up to almost half of reported economic growth.

In the second quarter of 2006, spending on durables was slightly negative. The contribution from nonresidential investment sagged to 0.28 percentage points, while residential construction made a swing from 0.5% to negative 0.4%. What prevented a steeper decline in GDP growth was a surge in consumer spending on services. Another positive contribution arose from falling imports, certainly reflecting weakening domestic spending.

There is no question that the U.S. housing bubble is finished. All remaining questions pertain solely to speed, depth and duration of the economy's downturn. Of decisive importance is, of course, the question

whether the two asset bubbles, housing and stocks, will burst with steep declines in prices, or whether they may stabilize after moderate losses.

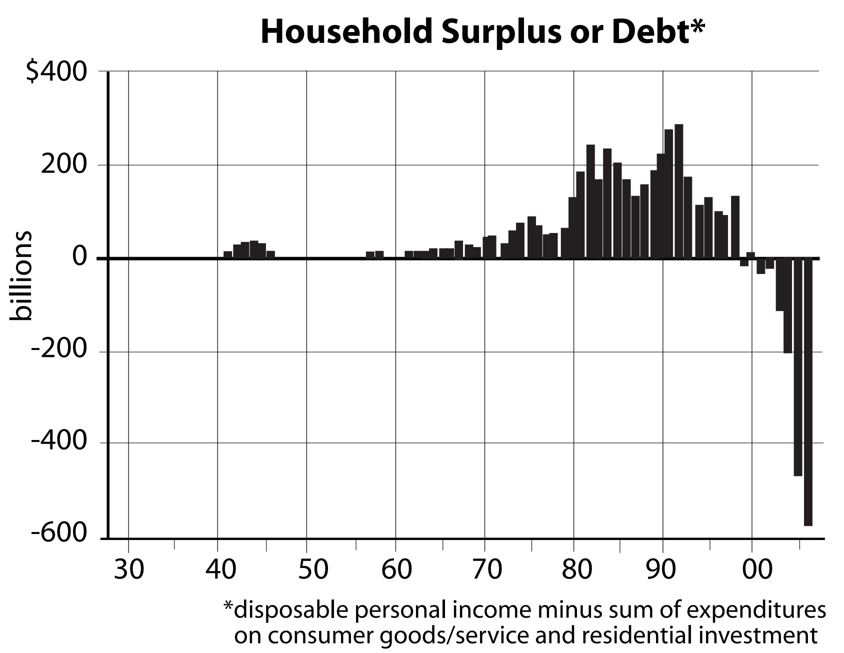
To be sure, this was not a typical housing cycle. It was a housing bubble that went with the help of a protracted period of ultra-cheap and ultra-loose money to unusually great excess. For this excess, the debt explosion in relation to GDP is the objective measure. In just five years, the American consumer has catapulted his outstanding indebtedness by 70%.

How much of U.S. real GDP growth in 2005 derived from consumer spending and residential construction? In short, 92%. In years past, this ratio used to be around 70%. Reasonable economists have calculated that around 40% of the poor job creation during this recovery has come directly and indirectly from the housing bubble. Just think of the numerous real estate agents and bank employees involved in the sale and financing of the houses, existing and newly built.

Construction and real estate are at all times the most important component in the transmission mechanism between monetary policy and the economy. It is the kind of spending that has the highest secondary effects in the economy, being both capital and labor-intensive. In the U.S. case of the last few years, it was absolutely predominant because the housing bubble additionally provided the ample credit facilities with which many millions of households replaced their missing income growth through borrowing.

Normally, private households run a financial surplus, spending less than their income and lending these funds to other sectors — businesses, government or foreign entities. In the United States, households run a huge deficit, spending more than their after-tax income. They borrow either from the business sector or from abroad.

In the first quarter of this year, households ran an annualized deficit of $588 billion. This is the amount that households spent on consumption and new housing in excess of disposable incomes. Anecdotal evidence suggests that their borrowing binge in the second quarter was of similar size.



Source: Paul Kasriel, Northern Trust

Oddly, while many American economists decry deficit spending by the government because it crowds out investment spending, they hail even bigger deficit spending by the consumer as something positive, although it has the very same damaging effect. You have to look at the chart and ask yourself whether this horrendous deficit spending by the consumer can be beneficial and sustainable or not. Any reasonable person will answer of course not.

It has been the great illusion of Mr. Greenspan and consorts that the many rate hikes will induce consumers and businesses to curb their credit demand. As the data show, credit demand has further exploded.

<u>OUT OF CONTROL</u>

There could never be any doubt that Mr. Bernanke is soft on inflation. He is paranoid about the slightest trace of deflation in consumer or producer prices. Just think of the deflation hysteria in 2003. He appears to hold the view that any inflation rate below 2% is suspect of deflation. America's annualized inflation rate over the last

three months has been 5.5%. Year over year, it is above 4%.

The U.S. economy's problem is that too many things are completely out of control, and this has its central cause in a credit expansion that has over the last few years escalated completely out of control in relation to economic activity. In 1997, it took total credit growth of $1,336.1 billion for real GDP growth of $374.6 billion. In 2005, it took credit growth of $3,335.9 billion to generate $345.1 billion of real GDP growth. Consider the drastic deterioration in the relationship between credit expansion and real GDP growth from year to year in particular since 2000.

Credit Expansion out of Control

	Credit growth	**GDP growth nom.**	**GDP growth real**	**Curr. acc. def.**	**Pers. sav. rate**	**Disp.** income**
1997	1,336.1	487.4	374.6	140.4	3.6	3.5
1998	2,045.0	442.7	363.4	213.5	4.3	5.8
1999	2,044.7	521.4	403.4	299.8	2.4	3.0
2000	1,605.6	548.6	346.7	415.1	2.3	4.8
2001	2,034.2	311.0	73.7	388.9	1.8	1.9
2002	2,171,1	341.6	158.1	472.4	2.4	3.1
2003	2,668.2	491.2	252.2	527.5	2.1	2.2
2004	2,800.8	751.7	402.5	665.2	2.0	3.6
2005	3,335.9	743.3	345.1	791.5	-0.4	1.2
2006	4,392.8*			834.8*	-1.0	1.7

* *annualized*
** *growth in chained dollars*
Source: Bureau of Economic Analysis

Earlier, we emphasized that all bubble economies ultimately end with three cataclysmic legacies: *first*, excessive debts; *second*, excessive asset valuations; and *third*, prior excessive spending. This pattern is diametrically opposite to the pattern of how the booms of the ordinary business cycle end. In their case, prior monetary tightness has caused reductions in debts and asset values and an accumulation of pent-up demand. Manifestly, the first scenario makes for totally ineffective monetary policy, while the second makes for the opposite.

The decisive event, really, is always the slumping asset values. Everybody agrees that over the past few years, soaring asset prices have been all-important in propelling the U.S. economy forward. It is simple logic to realize their equal importance in propelling the economy downward when asset prices slump.

The point to see is that this has huge balance sheet implications both for borrowers and lenders. In the case of Japan, the wealth destruction through collapsing stock and commercial real estate prices, confined to corporations, was equivalent to well over 250% of GDP. Stock prices fell 70% and commercial real estate prices by 85%.

Essentially, the extent of the following price declines depends largely on the extent of the prior excesses to the upside. According to Yale University economist Robert Shiller, residential real estate prices rose by all of 66% between 1890–2004, or just 0.6% a year. Between 1997–2005, they leapt by 52%, or 6.2% per year, in real terms.

America's house price inflation over the last few years has been by far the worst in history. And never forget, Messrs. Greenspan and Bernanke systematically engineered it with the loosest monetary policy in U.S. history.

Between 1997 and the first quarter of 2006, the market value of the residential housing stock, soared by 92.5%, to $20.2 trillion. Over the same period, personal indebtedness rose 80%, to $12.2 trillion. Net worth — asset values minus the increase in liabilities — increased 28%.

HOW WILL IT END?

All this leaves us with two speculations: What is the likelihood of a slump in U.S. asset prices? And what effect will this have on the U.S. economy? What does historical experience and economic analysis tell us?

From the study of the International Monetary Fund about bursting bubbles mentioned earlier, we learned three things about housing busts in the 1970–80s: *first*, that price corrections had averaged 30%, reflecting the lower volatility of housing prices and the lower liquidity in housing markets; *second*, that crashes lasted about four years; and *third*, that the association between booms and busts was stronger for housing than for equity prices.

In essence, these assessments by the IMF suggest that Mr. Greenspan made a great mistake in replacing the bursting equity bubble with an even larger housing bubble. The latter in its economic and financial effects is the much more dangerous species.

Drawing comparisons with the past, we note furthermore two major differences to worry about: *First*, total housing valuations have escalated out of proportion to income and GDP. In 1997, they were equivalent to 125% of GDP. In 2005, they hit a high of 163% of GDP. *Second*, today's U.S. housing bubble is not confined to rising house prices. It additionally has fueled big bubbles in consumer borrowing and spending, which have turned the house price bubble into the main motor of U.S. economic growth.

CONCLUSIONS:

Ultimately, every bubble economy ends with a clash between three cataclysmic legacies: prior excessive spending, excessive debt and excessive asset valuations prone to collapse. That is the gist of the analyses we have done on this question. It has to be realized that the U.S. economy and its financial system in the past few years have experienced the biggest asset and credit bubbles in U.S. history.

General folklore has it that Fed monetary tightening is slowing U.S. economic growth. This apparently assumes that the cessation of rate hikes and later rate cuts will reverse this slowdown. The ugly truth is that the housing bubble is dissipating and reversing even though the Fed has kept its money and credit spigots wide open.

The strain is not in lacking money or credit supply. It is, first of all, in the balance sheets of over-indebted private households that have incurred debts in many millions vastly in excess of their income potential. This is the main reason why major asset and credit bubbles in the United States inexorably end in high drama. Asset markets, both housing and stocks, are to come under protracted tremendous pressure with unstoppable momentum. Totally irresponsible borrowers met with totally irresponsible lenders.

THE RICHEBÄCHER LETTER

AGORA FINANCIAL

Dr. Kurt Richebächer, Editor
Published by Agora Financial
Addison Wiggin, Executive Publisher
Mandie Boardman, Marketing Manager

Richard Barnard, Associate Editor
Erik Kestler, Editorial Assistant
Beth Plambeck, Editorial Assistant
Susanne Krueger, Graphic Design

For subscription services and inquiries, please write to: THE RICHEBÄCHER LETTER, 808 St. Paul Street, Baltimore, MD, 21202. Subscription orders may be placed toll free from inside the U.S. by calling (888) 696-4508. Fax (410) 454-0407. Web: www.richebacher.com; richebacher@AgoraFinancial.com. Subscription rates: in the U.S.: $497. Outside U.S.: $545. Published monthly.